

## OVERVIEW OF EMPLOYMENT TAX FRAUD

By Robert J. Alter, Esq. <sup>1</sup>

I. Over the past several years, the IRS has stepped-up enforcement of payroll tax abuse.

A. For fiscal 2007 the Criminal Investigation Division of the IRS has made employment tax evasion a top enforcement priority – IRS special agents will be focusing on cases where individuals divert payroll taxes for private use (ex. enhancing lifestyle, offshore use, etc.), versus those situations where an individual diverts monies to keep a business afloat and individuals employed.

II. Recognizing Different Forms That Employment Tax Evasion Can Take And The Types of Employment Tax Schemes IRS Is Targeting:

A. Traditional garden variety “off the books” type cash payments to employees with false filings of Form 941 and W-2 understating wages paid; or for example, withholding correct amounts of taxes, but understating amounts withheld on Form 941; or owner of company filing false income tax return claiming his portion of false W2 withholding.

B. Pyramiding schemes – employer collects employment taxes, but fails to turn them over to IRS, dissolves company and creates new company and does the same thing.

C. Payroll leasing schemes – leasing company collects employment taxes from core business, but fails to remit taxes to IRS.

D. Phantom employees – owners of companies employing individuals (ex. children, etc.) that don't work and earn wages.

---

<sup>1</sup> Robert J. Alter is a member of Sills Cummis Epstein & Gross in Newark. A former IRS Office of Chief Counsel senior trial attorney, he represents business entities and individuals in matters ranging from civil tax audits, appeals and litigation to defending criminal tax investigations at both the federal and state tax authority levels.

E. Non-filing of payroll tax returns.

III. Sources of Employment Tax Evasion Investigations: Referrals from IRS Revenue Officers; complaints from employees/ex-employees; audit referrals – ex. filed currency transaction reports for large company's Friday cash withdrawals leads to execution of search warrant for second set of books.

IV. Potential Criminal Tax Charges In Employment Tax Cases

A. IRC §7202 felony for willful failure to collect or pay tax over.

1. Elements of the Crime:

Government must prove beyond a reasonable doubt (a.) Duty to collect, and/or truthfully account for and pay over; (b.) Failure to collect, or truthfully account for and pay over; and (c.)

Willfulness Note: Ninth Circuit in United States v. Poll, 521 F.2d 329 (9<sup>th</sup> Cir. 1975) and Wilson v. United States, 250 F.2d 312, 318 (9<sup>th</sup> Cir. 1958) has held there must be both a willful failure to account for and a willful failure to pay for there to be a crime, versus Second and Third Circuits view in United States v. Evangelista, 122 F.3d 112 (2d Cir. 1997), United States v. Thayer, 201 F.3d 214 (3d Cir. 1999) that either a failure to account or a failure to pay over will suffice to convict of a crime.

2. Statute of Limitations for offenses charged under IRC §7202 – Six-year limitation period applies to IRC §7202 prosecutions by virtue of IRC §6531 (4) United States v. Musacchie, 900 F.2d 493 (2d Cir. 1990) and United States v. Gollapudi, 130, F.3d 66, 70 (3d Cir. 1997), United States v. Porth, 426 F.2d 519, 522 (10<sup>th</sup> Cir. 1970) versus three-year statute of limitations under IRC §6531 held to apply to section 7202 prosecutions in United States v. Block, 497 F. Supp. 629 (N.D.G.A. 1980); United States v. Brennick, 308 F. Supp. 1004, 1018 (D. Mass. 1995). The limitation period begins running on the day on which the payments were

due by the employer, not the date that the payments were deemed to be made by the employer.

R.B. Creamer v. U.S., 370 F. Supp 2d 715 (D.C. Ill. 2005).

3. Due to willfulness element, government must prove beyond reasonable doubt that the taxpayer possessed sufficient funds to pay the tax, but refused to do so or that his/her failure to have the funds was a result of intentional conduct without justification in view of all the financial circumstances of the taxpayer. In general, evidence establishing circumstances beyond a taxpayer's control shows a lack of willfulness. Circumstances beyond a taxpayer's control would include financial difficulties beyond the taxpayer's control rendering him unable to pay the employment tax liabilities such as for example, theft, embezzlement, destruction of the business from fire or other casualty – not for example, because of payment of a responsible officer's children's wedding, mortgages on several personal residences, college tuitions, lease of luxury automobiles. In this regard, however, note that the Sixth Circuit has stated that financial difficulties are never a reasonable cause; they do not negate willfulness. Brewery, Inc. v. United States, 33 F3d, 589 (6<sup>th</sup> Cir. 1994) – contra, East Wind Indus v. United States, 196 F3d, 499 (3d Cir. 1999).

Furthermore, sustainable defenses can include a showing that there was a reasonable doubt as to whether the law required collection of the tax, or as to who was required by law to collect the tax.

Note: Possible downward departure type sentencing advocacy based on United States v. Brennick, 134 F.2d 10 (3d Cir. 1998) if proof exists of a sincere effort to “catch up” where delay in remitting taxes was temporary and there were legitimate business reasons for the non payment (e.g. failure of a third party to make payments for taxpayer).

B. IRC §7215 – Misdemeanor version of failure to collect or pay over.

Distinction between felony charge under section 7202 and misdemeanor charge under section 7215 is that a “lack of funds” type defense is excluded by the statute as a defense to the willfulness element of section 7215(b)(2) so that even if taxpayer didn’t have financial resources to pay tax, he or she could be convicted. Under section 7215, a person who fails to make withholding tax deposits after being put on notice under the procedures of section 7512 may be guilty of this misdemeanor.

C. Aiding and abetting the filing of false personal income tax returns of company’s employees under IRC §7206(2). Federal prosecutors charging in this manner for employers issuing false Forms W2 significantly increases tax loss under Federal sentencing guidelines since government allowed to aggregate each employee’s income taxes. See, United States v. Gambone, 314 F.3d 163 (3d Cir. 2003) where the government charged the owners of a construction company with 59 counts of aiding and abetting the filing of false personal income tax returns by the company’s employees who were paid straight overtime (rather than time and one-half) by nonpayroll checks without withholdings and in which gross amounts were not included in payroll tax returns (Form 941) or Form W-2s.

D. 18 U.S.C. §371 – Klein conspiracy charges have been pursued where taxpayers impair and impede the ability of the IRS to collect employment taxes.

E. IRC §7201 – Evasion of assessment and evasion of payment of tax (includes employment tax).

F. IRC §7206 – Includes filing false Forms 941, quarterly payroll tax returns.

G. IRC §7203 – Willful failure to file (includes employment tax returns) or pay tax (includes employment tax) misdemeanor.

H. IRC §7204 – Fraudulent or failure to make statement to employers.

I. IRC §7205 – Fraudulent withholding exemption certificate or failure to supply information.

V. Venue

The Sixth Amendment of the United States Constitution provides that trials shall be in the “State and district wherein the crime shall have been committed \*\*\*.” See Fed. R. Crim. P. Rule 18.

If a statute does not indicate where Congress considers the place of committing a crime to be, “the locus delicti must be determined from the nature of the crime alleged and the location of the act or acts constituting it.” United States v. Anderson, 328 U.S. 699, 703 (1046). Generally in payroll tax prosecutions, venue is proper in the judicial district in which the employer had his place of business.

VI. Potential Theories of Defense to Employment Tax Fraud Charges

A. Establish reasonable doubt as to whether collecting the taxes was required, or as to who was required to collect the tax – that is, that individual target did not have status, duty or authority – for example, titular head versus real financial decision making authority; individuals performing ministerial duties in following orders from individual(s) who make financial decisions in company.

B. Lack of willfulness related defenses – for example, establish that individual target lacked knowledge that taxes were unpaid; establish negligent type failure to remit versus willful, deliberate conduct.

## VII. Potential State Tax Criminal Exposure

Individuals regularly go to jail in state correctional institutions for stealing “trust funds” – withheld income tax withholdings and/or sales taxes. For example, New Jersey Division of Taxation’s Office of Criminal Investigation can pursue a second degree felony charge for purposefully failing to turn over withheld taxes aggregating over \$75,000 to the Director of the Division of Taxation which carries with it a sentencing presumption of incarceration for first time offenders.

### Voluntary Disclosure Policy

The IRS and many state taxing authorities have adopted such policies which offer relief prior to audit/informant contacts.